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SUBJECT: Argentina Economic and Financial Weekly for the week ending  
May 21, 2006

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Weekly Highlights  
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- Venezuela will buy USD 600 million in Boden 2012 bonds in July.
- ICSID rules against Argentina for USD 165 million.
- May monthly economic activity index up 8 percent y-o-y -- in line with market expectations.
- Fiscal primary surplus higher than expected, up 8.6 percent y-o-y on H1.
- Eight Latin-American presidents visit Argentina for annual Mercosur summit.
- Argentina and Chile will set new gas price during the Mercosur summit.
- Commentary of the Week: "The tax burden in Argentina is high and taxes are distortionary"

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Venezuela will buy USD 600 million in Boden 2012 bonds in July.  
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¶1. According to local media, the GOV will buy approximately USD 600 million of Boden 2012 bonds from the GOA through the end of the month. This will represent the largest purchase by the GOV in such a short period. Along with USD 1.4 billion deposited by the GOA in the Banco Nacion, it will be used to pay USD 2 billion of the Boden 2012 capital due. Presidents Hugo Chavez and Nestor Kirchner will also try to incorporate more countries in their "Bond of the South" project during this week's Mercosur meeting.

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ICSID rules against Argentina for USD 165 million.  
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¶2. The International Center for the Settlement of Investment Disputes (ICSID), an independent tribunal associated with the World Bank, ruled against Argentina in a case filed by US-based Azurix for USD 165 million, 29 percent of the amount demanded by Azurix. Azurix won a concession in 1999 to provide water and sewage services to various districts in Buenos Aires province; the provincial government rescinded the contract in 2001 due to disagreements over tariffs and after raising concerns about the water quality and lack of investments. Azurix then brought a claim against Argentina, arguing that the government's cancellation of the concession

violated the bilateral investment treaty signed between the United States and Argentina. There are 36 other lawsuits against Argentina registered in the ICSID, totaling USD 16 billion in claimed damages, many of which stem from the government's unwillingness to allow utility companies to raise tariffs.

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May monthly economic activity index up 8 percent y-o-y -- in line with market expectations.  
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13. The monthly economic activity index increased 8 percent y-o-y in May -- in line with the BCRA market survey forecast. This marks a sharp recovery after April, which showed the weakest growth rate (6.3 percent) in the past eight months, and it represents a reprieve from the downward trend that followed the 9.1 percent increase in January. However, slower performance in April and March was in part due to seasonal effects. May's index growth came from a 6.9 percent increase in the service sector (mainly from the financial and communication sectors) and a 5.1 percent increase in goods (mainly from industry and construction). The latest BCRA consensus survey estimates 7.7 percent growth in economic activity for 2006, unchanged from its previous forecast. The monthly economic activity index is viewed as a reliable leading indicator of GDP.

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Fiscal primary surplus higher than expected, up 8.6 percent y-o-y on H1.  
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14. According to Ministry of Economy figures, public accounts showed an ARP 13 billion primary surplus in the first semester of 2006, 8.6 percent up against H1 of 2005. This increase was partially offset by a record in current expenses, reaching ARP 74 billion (+21.1 percent y-o-y) due to debt payments and wage increases. In June,

the primary surplus reached ARP 2 billion (+24.5 percent y-o-y). The financial surplus (considering debt servicing) reached ARP 8 billion (+38.1 percent y-o-y). The improved performance was a result of fewer interest payments coming due. The fiscal primary surplus was a 20.6 percent higher than scheduled and allowed the Treasury to reach 64.2 percent of the results projected for 2006.

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Eight Latin-American presidents visit Argentina for annual Mercosur summit.  
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15. From July 20-21, eight Latin-American presidents gathered in the Argentine province of Cordoba. The group consisted of the presidents of Mercosur member countries (Argentina, Brazil, Paraguay, Uruguay and the newest member, Venezuela) and the presidents of Chile, Cuba and Bolivia. Participants discussed a trade agreement between Mercosur and Cuba under the Common Market Group (GMC), while other topics like natural gas prices (involving Argentina, Chile, Brazil and Bolivia) and the pulp mills projects (involving Argentina and Uruguay) were addressed in bilateral conversations.

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Argentina and Chile will set a new gas price during the Mercosur summit.  
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16. On July 15, the new price agreement between the GOA and the Government of Bolivia went into effect, increasing the price of natural gas from USD 3.20 to USD 5 per million cubic meters through the end of the year. In light of that increase, the GOA has begun negotiations with the Government of Chile to determine a new price for Argentine gas exported to Chile (Chile buys 90 percent of Argentine gas exports). The final decision will be reached during a meeting between Argentine President Nestor Kirchner and Chilean President Michelle Bachelet on July 21. Bachelet will also present a complaint about a recent GOA decision to raise diesel oil prices for foreigners purchasing near the country's borders.

The BCRA announces that inflation will continue falling.

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¶7. On July 19, the BCRA announced that inflation will continue falling in coming months. According to the report presented by the BCRA, this slowdown is caused by the GOA's monetary and fiscal policies. The BCRA also highlighted other economic indicators, saying that economic growth will remain solid, the labor market will continue its recovery and that real wages will continue to rise as they did last year.

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Minimum, Vital and Mobile Wage Council will meet July 27.

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¶8. The GOA called a meeting of the Minimum, Vital and Mobile Wage Council for July 27 in order to consider adjusting workers' basic salaries. Labor union leaders will propose increasing the minimum wage from ARP 630 to ARP 870; this 38 percent raise is well above the 19 percent proposed by the GOA. The Minimum, Vital and Mobile Wage Council is composed of union leaders, employers and government employees.

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The GOA will restructure provinces' debt by the end of the year.

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¶9. The GOA will begin negotiations to restructure the provinces' debt this year. The debt currently stands at ARP 78 billion, and the GOA holds ARP 47 billion. This negotiation will take place in light of financial troubles facing the provinces. The GOA has two options: stop indexing the debt to the CER index (a CPI-linked index) or extend the terms of payment. In a recent meeting, Economic Minister Felisa Miceli urged the provinces to show fiscal restraint and warned six of them (Chaco, Formosa, San Juan, Jujuy, Rio Negro and Tucuman) about their high debt-to-income ratios.

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Argentina and United States sign anti-money laundering agreement.

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¶10. On July 18, the head of the Argentine tax authority, Alberto Abad, and United States Ambassador Lino Gutierrez signed an agreement establishing a Trade Transparency Unit (TTU), which will gather real-time information on imports and exports passing through both customs houses. The two countries will share information to improve detection of money laundering operations and tax evasion. The pan will be operational in 30 days and will provide information not only on the quantity of goods passing between the countries but also on their value.

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Argentina holds off on forgiving Paraguayan debt on Yacyreta.

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¶11. In a surprise move, Argentine President Nestor Kirchner and Paraguayan President Nicanor Duarte Frutos signed an agreement to study ways to restructure the debt the Yacyreta power station owes to the GOA. Just a day earlier, Paraguay had announced that the GOA would forgive nearly half (USD 5 billion) of Yacyreta's debt. Instead, over the next 90 days a joint commission will investigate how to reduce Yacyreta's debt of roughly USD 11 billion owed to the GOA. Co-owned by the two countries, Yacyreta is one of South America's largest power projects. The GOA financed the construction of Yacyreta in the 1980s. Paraguay claims that interest on the debt was unfairly calculated and fears the company's liabilities could impede expansion projects in the future. Kirchner has said that any decision on the power station's debt should be ratified by each country's legislators.

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June industrial production index up 8.9 percent y-o-y.

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¶12. The industrial production index increased 8.9 percent y-o-y in June, well above market expectations of 7.7 percent and marking a significant acceleration following a 7.3 percent increase in May.

During June, the fastest growing sectors were car production (+32.6 percent), non-metallic minerals (+31 percent), oil refining (+12.1 percent) and base metal industries (+8.5 percent). The index decreased 0.3 percent m-o-m without seasonal adjustment and increased 0.9 percent m-o-m seasonally adjusted. The BCRA consensus survey forecasts 6.9 percent industrial production growth for 2006 -- unchanged from last month's forecast.

¶13. The industry-wide capacity utilization index reached 71.9 percent in June, up slightly from 71.2 percent in June 2005. The sectors with the highest capacity utilization rates were metal-based industries (97.6 percent), oil refining (94.6 percent) and textiles (87.1 percent). The sectors with the lowest capacity utilization rates were auto production (54.3 percent), tobacco (60.6 percent) and non-metallic minerals (63.1 percent).

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Multilateral real exchange rate appreciates 1.2 percent m-o-m in June.  
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¶14. The BCRA's multilateral real exchange rate index -- which measures the real exchange rate between the peso and a trade-weighted basket of currencies -- appreciated 1.2 percent m-o-m in June. The real appreciation is mainly explained by the depreciation of the Brazilian real and Euro against the peso, partially offset by an appreciation of the dollar against the peso. The index is 3.7 percent above the level twelve months ago and 104.2 percent above its average value during convertibility. [The BCRA's multilateral real exchange rate index weighs domestic prices and the exchange rates of Argentina's main trading partners according to their share of Argentina's exports and imports.]

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BCRA rolls over its maturities. Investors showed great interest in the BCRA's instruments.  
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¶15. The BCRA received ARP 1.2 billion in bids at its July 18 Lebac and Nobac auction, compared to ARP 279 million in Lebac bids that came

due during the week. It accepted ARP 342 million in Lebac bids and ARP 644 million in Nobac bids. The yield on the 91-day Lebac was 7.39 percent, the 168-day Lebac remained at 8.50 percent and the yield on the 238-day Lebac decreased from 10.06 percent to 10 percent. The yield on the longest term instrument, the 357-day Lebac, decreased from 12.15 percent to 12.05 percent. Lebac bids for maturities of more than 357 days were withdrawn due to lack of interest by the BCRA. The spread on the one-year Nobac decreased from 2.10 percent to 2.08 percent and the two-year Nobac spread was 3.78 percent. The Badlar rate (the base rate for Nobacs) is currently at 9.2 percent. Investors showed great interest in the BCRA's instruments with bids four times larger than the amount that came due.

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The peso is unchanged against the USD this week, closing at 3.10 ARP/USD.  
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¶16. The peso remained flat versus the USD this week, closing at 3.10 ARP/USD. The BCRA continued purchasing dollars to keep the peso from falling against the USD. In the first three days of the week, the BCRA purchased USD 198 million. The peso exchange rate has depreciated 1.6 percent since the beginning of the calendar year. The BCRA's reserves stood at USD 26.1 billion as of July 18, and have increased USD 7.5 billion, or 40 percent, since the GOA prepaid its entire IMF debt on January 2.

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Commentary of the Week: "The tax burden in Argentina is high and taxes are distortionary", by Daniel Artana, from an article published in Ambito Financiero on June 7.  
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¶17. The above statement should be made carefully. Argentina is a country with a federal system and the three levels of government collect taxes, while in unitary countries like Chile or France, the

federal government obtains the bulk of collections. Also, for those countries that replaced the government pay-as-you-go pension system with a private system, the tax burden will be lower than in those countries that maintain a state-run pension system (as is the case in Brazil).

¶18. Even more importantly, the tax burden tends to grow with the level of development. There are various conceptual arguments that support this statistical regularity. For example, the most developed countries have deeper financial markets, and this facilitates the work of the tax administration and, in general, they have greater formal employment, which allows income taxation to be more important than in the case of developing countries. Furthermore, if the desired consumption of public goods increases faster than the level of income rises, development will be accompanied with a greater desire for these types of goods (and for paying taxes to finance them).

¶19. The attached graphic shows the tax burden on the consolidated public sector among developed and developing countries. The regression line shows a positive relationship between the level of development (measured in GDP per capita adjusted for purchasing power parity) and the tax burden. Clearly, Argentina's tax burden (including all three levels of government) is high compared to its level of development. It is the second-highest in Latin America after Brazil, and it is much higher than what is observed among economies with high growth rates, like Chile or countries in Asia.

¶20. Furthermore, the tax burden is even higher in the private formal sector. In the case of Argentina, we have estimated it to be around 40 percent, similar to what is observed in Spain. Clearly, Argentine businesses do not have the same ease of access to the European Union market as the Spanish or the same legal security or institutional pathways.

¶21. Finally, besides being higher, the form in which collections are obtained is not optimal. In the case of the federal government, withholdings and the financial transaction tax contribute around 4 percent of GDP. Other developing countries impose export taxes, but in a timely manner upon determined export commodities, not in a more generalized way, as is done in Argentina with an average rate of 10

percent on foreign sales. Also, the financial transaction tax, which is imposed in only few developing countries, is extremely high. For example, the effective tax rate in Argentina is three times higher than in Brazil. (Note: We reproduce selected articles by local experts for the benefit of our readers. The opinions expressed are those of the authors, not of the Embassy. End Note.)

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